

Message Text

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ACTION EUR-12

INFO OCT-01 EA-06 ISO-00 NEA-09 IO-10 AID-05 CIAE-00

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FM AMEMBASSY LONDON

TO SECSTATE WASHDC 0522

INFO AMEMBASSY BONN

AMEMBASSY BRUSSELS

AMEMBASSY COPENHAGEN

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DEPARTMENT PASS TREASURY AND FRB

E.O. 11652:N/A

TAGS: EFIN, UK

SUBJECT: THE UK BUDGET: A LONGER VIEW

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BEGIN SUMMARY: A LONGER SECOND LOOK AT THE APRIL 15 BUD-

GET REINFORCES OUR VIEW THAT IT WILL TEND TO SLIGHTLY REDUCE ECONOMIC ACTIVITY AND INFLATIONARY PRESSURE IN THE SHORT RUN WHILE, AT THE SAME TIME, GIVING A ONE-TIME BOOST TO THE PRICE LEVEL. HOWEVER, IT RAISES AS MANY QUESTIONS AS IT ANSWERS AND, IN THE LONG RUN, ITS IMPACT COULD BE HIGHLY INFLATIONARY IF IT IS NOT SUPPLEMENTED WITH FURTHER MEASURES LATER THIS YEAR. OTHERWISE THE IMMENSE PUBLIC SECTOR BORROWING OF THIS FISCAL YEAR AND THE LIKELY LARGE ONE NEXT YEAR WILL SPEED UP THE GROWTH OF MONETARY AGGREGATES WHICH, IN TURN, COULD INCREASE INFLATION THROUGH AN IMPACT ON DEMAND AND ON WAGES. HEALEY CONTINUES TO ISSUE STRONG WARNINGS ABOUT WAGE ESCALATION, AND HE MAY NOW BE LAYING THE GROUNDWORK FOR A SECOND, TOUGHER BUDGET FOLLOWING THE JUNE REFERENDUM ON EC MEMBERSHIP. END SUMMARY

1. THE APRIL 15 BUDGET APPEARS TO BE A FIRST STEP IN A STRATEGY TO COMBAT THE INFLATIONARY PRESSURES IN THE BRITISH ECONOMY WHILE IMPLEMENTING THE GOVERNMENT'S LONG RANGE ECONOMIC PROGRAM. THE BUDGET FEATURES TAX INCREASES IN THE PRESENT FISCAL YEAR, BOTH IN DIRECT PERSONAL AND INDIRECT TAXES, AND PROMISES OF PUBLIC EXPENDITURE CUTS NEXT FISCAL YEAR, BOTH WITH THE AIM OF REDUCING THE MASSIVE PUBLIC SECTOR DEFICIT AND BORROWING REQUIREMENT, THUS DIMINISHING THE IMPACT OF THE PUBLIC SECTOR DIRECTLY ON DEMAND THROUGH SPENDING AND INDIRECTLY THROUGH MONETARY GROWTH. AT THE SAME TIME, THE INCREASES IN INCOME TAX ARE A DIRECT WARNING TO UNIONS THAT INFLATIONARY WAGE SETTLEMENTS WILL BE TAXED BACK. IN A LONGER RUN CONTEXT, KEEPING A LID ON CONSUMPTION THROUGH INCREASES OF DIRECT AND INDIRECT TAXES IS CLEARLY CONSISTENT WITH THE GOVERNMENT'S ECONOMIC STRATEGY OF INDUCING THE MOVEMENT OF RESOURCES TO THE EXTERNAL SECTOR AND TO INVESTMENT.

2. AS AN ADDED INDUCEMENT TO THIS RESOURCE SHIFT, HEALEY ANNOUNCED THAT A FACILITY TO GUARANTEE LOANS FOR PRE-SHIPMENT FINANCE ON LARGE EXPORT PROJECTS WILL BE IMPLEMENTED (NO DETAILS YET AVAILABLE) AND THAT THE PRICE CODE WOULD BE FURTHER AMENDED RAISING THE RELIEF FROM LIMITS ON PRICE RISES GRANTED TO INVESTMENT PROJECTS FROM 17-1/2 TO 20 PERCENT, EXTENDING THIS RELIEF TO COMMERCIAL VEHICLES AS LIMITED OFFICIAL USE

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WELL AS TO INVESTMENT PROJECTS SOLELY FOR EXPORTING, AND GIVING THE SECRETARY OF STATE FOR PRICES POWER TO PROVIDE OTHER PRICE CODE RELIEF TO ASSIST THE BALANCE OF PAYMENTS. THE PRICE CODE RELIEF FOR 17-1/2 PERCENT OF INVESTMENT PROJECTS WAS ORIGINALLY INTRODUCED IN THE "MAXI-BUDGET" OF NOVEMBER. PRICE COMMISSION SOURCES TELL US THAT THE NUMBER OF APPLICATIONS UNDER THE PROVISION WAS SMALL AND THE CHANGES ARE AN ATTEMPT TO "SWEETEN THE INDUCEMENT" AND

HELP INVESTMENT AND THE EXPORT SECTOR. THE BUDGET ALSO INCLUDED A MINOR INVESTMENT PROGRAM DIRECTED AT SPECIFIC INDUSTRIES.

3. HEALEY'S CONCERN ABOUT THE FINANCIAL POSITION OF THE COMPANY SECTOR CONTINUES. THE TAX RELIEF ON INVENTORY APPRECIATION WILL CONTINUE. MANY OBSERVERS NOW CONSIDER THE CORPORATE LIQUIDITY SQUEEZE TO BE OVER. IN FACT, ONE PROMINENT ANALYST, GORDON PEPPER OF GREENWELL'S SUGGESTS IN THE LATEST GREENWELL BULLETIN THAT THE COMPANY AND PERSONAL SECTOR WILL BE IN FINANCIAL SURPLUS THIS YEAR WHILE THE PUBLIC AND EXTERNAL SECTORS WILL BE IN LARGE DEFICIT. PEPPER, WHO LARGELY USES FLOW OF FUNDS ANALYSIS, STATES THAT THIS ADDS UP TO A RUN ON STERLING SOMETIME IN L975.

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FM AMEMBASSY LONDON

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4. THE BUDGET'S TAX INCREASES IN THIS FISCAL YEAR ARE PRE-
DICTED TO REDUCE THE PUBLIC BORROWING REQUIREMENT FROM ITS
PROJECTED 10.2 BILLION POUNDS TO 9 BILLION POUNDS. HEALEY
STATED IN HIS BUDGET MESSAGE THAT HE WILL CUT PUBLIC EX-
PENDITURE NEXT FISCAL YEAR BY 1.1 BILLION POUNDS (900
MILLION POUNDS IN 1974 PRICES) AND THAT THIS PLUS THE TAX
RISES SHOULD BRING THE 1976/77 PUBLIC SECTOR BORROWING RE-
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QUIREMENT DOWN BY 3 BILLION POUNDS. (HEALEY ADDED THAT AN
UPSWING IN ECONOMIC ACTIVITY WHICH HE CONFIDENTLY EXPECTS
COULD REDUCE THE BORROWING REQUIREMENT BY A FURTHER FEW
BILLION POUNDS.) THERE WAS NO MENTION OF HOW MUCH THE
REQUIREMENT WOULD HAVE BEEN BEFORE THE BUDGET CHANGES NOR
OF ITS EXPECTED LEVEL AFTER THEM, HOWEVER, BUT THE SIMPLE
ARITHMETIC OF INFLATION AND INCREASING REAL PUBLIC EXPEN-
DITURE LEADS US TO BELIEVE THAT THE FIGURE BEFORE OR AFTER
WILL BE LARGE. THE PROBLEM IS PUBLIC EXPENDITURE ITSELF
WHICH IS ALMOST OUT OF CONTROL IN THE UK. IN MARCH 1974,
THE PUBLIC SECTOR BORROWING FOR THE 1974/75 FISCAL YEAR
WAS ESTIMATED AT 2.7 BILLION POUNDS. BY NOVEMBER, CHAN-
CELLOR HEALEY PROVISIONALLY ESTIMATED IT AT 6.3 BILLION
POUNDS. IN THE EVENT, THE BORROWING REQUIREMENT FOR THE
FISCAL YEAR JUST PASSED WAS 7.6 BILLION POUNDS. NORMALLY
IN A TIME OF RECESSION, THIS WOULD BE ASCRIBED TO THE
NATURAL FALL OF REVENUES AS INCOME FALLS. BUT THE RECESS-
IONARY IMPACT ON UK REVENUES HAVE BEEN MORE THAN OFFSET BY
THE IMPACT OF THE RAPID BRITISH WAGE INFLATION. THE
FINANCIAL STATEMENT, ISSUED WITH THE BUDGET, INDICATES
THAT CURRENT REVENUES ROSE BY 25 PERCENT FROM THE 1973/74
FISCAL YEAR TO THE 1974/75 FISCAL YEAR. AT THE SAME TIME,
CURRENT EXPENDITURE OF THE CENTRAL GOVERNMENT IN 1974/75
WAS 4.6 BILLION POUNDS ABOVE ITS ESTIMATE OF MARCH 1974.
PUBLIC EXPENDITURE IN THE UK IS DIFFICULT TO CONTROL BE-
CAUSE OF WAGE INFLATION WHICH HITS THE PUBLIC SECTOR HARD
HERE (A LARGE WAGE BILL IN THE PUBLIC SECTOR AND LARGE
WAGE INCREASES RECENTLY), AND OF COURSE, BECAUSE OF PRICE
INFLATION FOR THE GOODS GOVERNMENT PURCHASES. THE CENTRAL
GOVERNMENT ALSO HAS INADEQUATE CONTROL OVER THE LOCAL
AUTHORITIES WHERE EXPENDITURE HAS SOARED IN THE PAST 2

YEARS, MAINLY ON HOUSING. WHETHER THIS PROBLEM CAN BE CONTROLLED AND PUBLIC EXPENDITURE GROWTH LIMITED (AND THE CUTS PROMISED NEXT FISCAL YEAR ACTUALLY IMPLEMENTED) IS NOT CLEAR. THE GOVERNMENT WILL BE HINDERED IN ITS EFFORTS BY THE CONTINUATION OF WAGE AND PRICE INFLATION, AND THE ATTITUDE OF MANY OF THE LABOR PARTY, ESPECIALLY ON THE LEFT, THAT MORE EXPENDITURE IS REQUIRED ON SOCIAL PROGRAMS AND ON INTERVENTION IN INDUSTRY.

5. THUS, EXPANDING (AND PERHAPS UNCONTROLLABLE) PUBLIC LIMITED OFFICIAL USE

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EXPENDITURE WILL ADD TO THE PUBLIC SECTOR DEFICIT THIS FISCAL YEAR AND NEXT. IN THE FISCAL YEAR JUST PASSED, THIS LARGE PUBLIC SECTOR BORROWING WAS FINANCED MAINLY BY THE CURRENT ACCOUNT DEFICIT ON BALANCE OF PAYMENTS AND BY THE SALE OF GILTS (GOVERNMENT SECURITIES) TO THE NON-BANK PUBLIC. THE CONDITIONS WHICH LED TO THESE FINANCING METHODS LAST FISCAL YEAR MAY NOT OBTAIN IN THE FUTURE.

6. THE CURRENT ACCOUNT DEFICIT OF THE UK IS SHRINKING -- IN FACT IN MARCH THE UK HAD A CURRENT ACCOUNT SURPLUS, HOWEVER, MOST OBSERVERS AGREE THIS WAS THE RESULT OF TECHNICAL ANOMOLIES. NONETHELESS, IT APPEARS THAT THE TREND ON UK CURRENT ACCOUNT IS TOWARD IMPROVEMENT. AS THE CURRENT ACCOUNT IMPROVES, THERE WILL BE LESS FINANCING OF PUBLIC SECTOR BORROWING FROM THIS SOURCE. THUS, IT MUST COME FROM SALE OF GILTS OR FROM BORROWING FROM THE BANKING SYSTEM (THE LATTER CAN ADD TO THE MONEY SUPPLY).

7. GILT SALES HAVE BEEN STRONG RECENTLY, AND WERE STRONG IN MUCH OF 1974 BECAUSE OF EXPECTED FALLS IN INTEREST RATES. HOWEVER, 1975 MAY SEE A REVERSAL OF THIS TREND. IF US INTEREST RATES, UPON WHICH BRITISH INTEREST RATES ARE KEYED, BEGIN TO RISE, THEN UK INTEREST RATES WILL ALSO RISE, AND THE SALE OF GILTS WILL WEAKEN.

8. THUS, THERE IS LITTLE DOUBT THAT THE PRESSURE ON THE MONEY SUPPLY FROM PUBLIC SECTOR BORROWING WILL INCREASE IN THE LATTER PART OF THIS FISCAL YEAR AND IN THE NEXT FISCAL YEAR AS THE GOVERNMENT TURNS TO THE BANKS TO FINANCE ITS DEFICIT. WHILE THE ECONOMY IS IN RECESSION AND BE- CAUSE CORPORATE FINANCIAL PROBLEMS ARE NOW RECTIFIED THERE COULD BE A SIZABLE DECREASE IN BANK LENDING TO THE PRIVATE SECTOR WHICH WOULD OFFSET THE INCREASED BANK LENDING TO THE PUBLIC SECTOR. BUT AS ECONOMIC ACTIVITY PICKS UP, PRESSURES ON MONETARY GROWTH COULD BECOME FIERCE.

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9. A RELATED INFLUENCE IS THE IMPACT OF AN INCREASING
MONEY SUPPLY ON WAGES. THE POLITICAL PROBLEM OF WHETHER
UNIONS WILL MAKE LARGE WAGE CLAIMS IS SEPARATE. BUT
ASSUMING THEY DO, AN EXPANDING MONEY SUPPLY LATE THIS YEAR
AND NEXT WOULD PROVIDE THE FUEL TO MEET SUCH WAGE CLAIMS
AND LOWER THE RESISTANCE OF EMPLOYERS TO RESIST THEM.

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10. APART FROM THIS IS THE PROBLEM OF THE UNIONS THEMSELVES AND THEIR RESPONSE TO THE BUDGET. IT IS WIDELY FEARED THAT THEY WILL REACT TO REDUCED REAL INCOME (VIA THE TAX INCREASES) BY UPPING THEIR WAGE DEMANDS. WHETHER THIS IS SO WILL NOT BE CLEAR UNTIL THE NEXT WAGE ROUND, BEGINNING THIS FALL, ALTHOUGH SOME UNIONS MAY ENDEAVOR TO ACCELERATE THE TIMING OF WAGES AS WELL AS THE AMOUNT CLAIMED.

11. THUS, IN OUR ESTIMATION, THE BUDGET IS NO GUARANTEE OF A REDUCTION IN THE RATE OF INFLATION. IN THE SHORT TERM, THE LEVEL OF WAGE INCREASES IS CRUCIAL, TO WHICH MUST BE ADDED THE ABILITY OF THE GOVERNMENT TO CONTROL GROWTH OF PUBLIC EXPENDITURE. IF THESE CANNOT BE RESTRAINED THEN THE HUGE PUBLIC SECTOR BORROWING REQUIREMENT, IN ADDITION TO THE OTHER ELEMENTS, WOULD ADD TO THE EXISTING RATES OF DOMESTICALLY GENERATED INFLATION. OF COURSE, THE EFFECTS OF REDUCED CONSUMER SPENDING VIA DECREASED ECONOMIC ACTIVITY AND INCREASED UNEMPLOYMENT ON WAGES AND PRICES MUST NOT BE TOTALLY DISREGARDED. THE BUDGET MEASURES WILL HAVE SOME DAMPENING EFFECT ON PRICES, BOTH THROUGH THE PHILLIPS CURVE EFFECT ON WAGES AND THROUGH REDUCED ACTIVITY ON PRICES. BUT 1969/72 EXPERIENCE IN THE UK HAS NOT SHOWN THAT PRICES AND WAGES ARE HIGHLY AND/OR QUICKLY RESPONSIVE TO REDUCED BUSINESS ACTIVITY AND INCREASED UNEMPLOYMENT. THUS, IT COULD PERHAPS BE SAID THAT MR. HEALEY SHOULD HAVE GONE MUCH FURTHER BOTH IN REDUCING REAL INCOME AND IN MOVING TO REDUCE THE PUBLIC SECTOR DEFICIT. BUT, IN POLITICAL TERMS MANY FEEL HE WENT ABOUT AS FAR AS HE COULD IN THE RIGHT DIRECTION. A SENIOR UK TREASURY OFFICIAL CALLED THE BUDGET "A TURNING POINT." BUT THAT IS ALL IT CAN BE SAID TO BE, AT BEST. IT HAS INCIPIENT LONG RUN INFLATIONARY BIAS AND ITS TENTATIVE MEASURES TO REDUCE CONSUMER SPENDING ARE PROBABLY NOT ENOUGH TO OFFSET THIS. HEALEY, HOWEVER, HAS QUICKLY FOLLOWED THE BUDGET WITH STRONG WARNINGS ABOUT THE DANGER OF CONTINUED WAGE ACCELERATION. HE IS NOW SAYING PUBLICLY THAT IF UNIONS DO NOT ADHERE TO THE "SOCIAL CONTRACT" HE WILL BE FORCED TO MAKE "SAVAGE CUTS" IN PUBLIC EXPENDITURE ON SOCIAL SERVICES. AS HE REPEATEDLY WARNED OF TAX INCREASES IF WAGES CONTINUED TO ACCELERATE BEFORE THIS BUDGET THUS SETTING THE STAGE

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FOR THE MEASURES HE TOOK, IT IS NOT UNLIKELY THAT HE IS BEGINNING TO LAY THE GROUNDWORK FOR A SECOND BUDGET SOME-

TIME AFTER THE EC REFERENDUM IN WHICH STEPS TO FURTHER
REDUCE THE PUBLIC SECTOR BORROWING REQUIREMENT THROUGH
CUTS IN PUBLIC EXPENDITURE WILL BE ATTEMPTED. THE ALTER-
NATIVES ARE SOME SORT OF TOUGHER INCOMES POLICY OR A
SIEGE ECONOMY, WHICH DO NOT APPEAR LIKELY.

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